DOCUMENT RESUME

ED 161 462 JC 780 438

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TITLE Analysis of Income/Commercial Real Estate Transactions.
PUB DATE 78
NOTE 75p.

EDRS PRICE MF-$0.83 HC-$3.50 Plus Postage.
DESCRIPTORS Construction Industry; Credit (Finance); Finance Occupations; *Housing Industry; Investment; Mathematical Formulas; Professional Continuing Education; *Property Appraisal; *Real Estate; Real Estate Occupations; Risk; *Textbooks

ABSTRACT

Basic concepts in long- and short-term financing of real estate property are discussed in this text for real estate personnel. Two of the more important of these are leverage, the relationship between the return received by the equity and mortgage investors, and risk, the assessment of the probability that all or part of the investment may be lost. Financial analysis is discussed in terms of balance sheets, profit and loss statements, lease coverage, and financial statements. Loan underwriting is considered by type of real estate, including apartments, prime credits, local and regional credits, shopping centers, offices/warehouses, multi-tenant office buildings, medical office buildings, mobile home parks, hotels and motels, and nursing homes. Short-term underwriting is examined with regard to land acquisition loans, land development loans, and construction loans with and without permanent mortgage commitments; and intermediate term loans are discussed. A glossary of commercial loan terminology and samples of appraisal calculations are included. (MB)

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ANALYSIS OF INCOME/COMMERCIAL REAL ESTATE TRANSACTIONS

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OVERVIEW

OVERVIEW

The purchase, sale, and financing of real property plays an extremely important role in our economy. More people own real estate equities than own any other type of equity. The construction industry is the single largest industry in this country. The financing of real property constitutes by far the largest use of all the net savings and funds that flow into our financial institutions and money markets.

Because individual properties typically cost more than the owner is worth, or at least cost more than the owner is willing or able to invest at the time, the concept of mortgage financing exists. With rare exceptions, therefore, real estate is paid for partially through equity investment - the cash the owner is willing and able to supply, and partially through mortgage investment - the cash some outside entity is willing and able to supply. These two kinds of investments, equity and mortgage, are quite similar in two respects. Both investors are seeking a return on their investments, a payment for the use of funds. Also, both investors are seeking, at some point in time, to recover their investments. These two similarities give rise to the two most important terms in real estate. These terms are leverage and risk.

Leverage is the relationship between the return or yield received by the equity investor and the return or yield received by the mortgage investor. If the equity investor receives a greater return on his investment than the mortgage investor he has positive leverage. If he receives a lower return, he has negative leverage. Logically, then, it makes sense for the equity investor to continue to push the mortgage investor to invest a larger and larger percentage of the total until such time as his return begins to drop. For example, if I can borrow money from the bank at 7% and invest it to yield 10%, logically I should do just that. However, if the money cost rises to 10% at the bank, for some reason, then it doesn't make sense to continue, because there is no longer a profit.

Risk, very simply, is an assessment of the probability that all or part of the investment may be lost. There have been many attempts to quantify risk. Let it suffice to say that it is an inexact science. For purposes of our discussion it is only necessary to know how it relates to loan types and to understand that it directly relates to interest rates.

The concept of risk will relate primarily to our discussion of short-term financing, while leverage will relate primarily to our discussion of long-term financing.

Our discussions will be focused primarily on long-term financing which will include apartments, office buildings, industrials, and shopping centers. We will touch on some of the more exotic kinds of financing such as wrap-arounds and land-sale leasehold mortgages. We will spend some time on land acquisition and development loans and construction loans. In the short period you will be "in class", we can't possibly hope to make you experts. Remember that common sense and good reliable information will be your best tools. Focus your attention on what makes a good package, how to locate good information, and how to locate and cultivate good commercial deals. In order to advise your clients you should become familiar with Lender attitudes and analysis. Generally, few projects can proceed without the Lender supplying mortgage funds. The Lender's analysis may be slightly too conservative but using such analysis will be a good dose of "REALITY THERAPY" to the typically highly optimistic developer/seller and the generally, unsophisticated, but anxious, buyer.

GLOSSARY

GLOSSARY OF COMMERCIAL LOAN TERMINOLOGY

LEASES

Gross Lease - Owner (lessor) pays some of the expenses incidental to the real estate, normally including taxes, insurance, utilities, maintenance, etc. Most apartment leases are of this type. Most retail store or industrial "gross" leases provide that owner (lessor) pays only taxes, insurance and exterior and structural maintenance. Tenant (lessee) pays all utilities and maintenance of the interior and non-structural portions of the real estate.

Absolute Net Lease - Tenant (lessee) pays all expenses including taxes, insurance, utilities and maintenance, except for structural maintenance.

Note: Avoid the use of the term "net-net lease" because this means different things to different people and results in considerable confusion. It is better to identify specifically what the landlord must pay for.

Space Lease - This term is used to differentiate between leases affecting usable space within a building (such as a store or office) as against a land (ground) lease.

Ground or Land Lease - A lease affecting only land, usually written for a considerably longer term than a space lease. These are almost always "absolute net" leases, i.e., the tenant (lessee) pays taxes, special assessments, etc.

Subordinated Ground Lease - A ground lease which specifies that, regardless of the date a specifically mentioned mortgage was recorded the mortgage shall be a prior lien on the real estate, i.e., prior to the lien created by the ground lease.

In effect, this means that the owner of the land (the land lessor -- sometimes referred to as "fee owner") signs the mortgage, but not the note -- in other words, he pledges his land as security for the mortgage loan but is not obligated to repay the debt. However, in case of default on the mortgage loan, the land owner (lessor) would be wise to take over the mortgage payments or else he would lose his land through foreclosure. Because a mortgage foreclosure wipes out the subordinated ground lease, the value of the land is included in the appraisal of the property even though the borrower does not actually own the land. However, an expense for ground rent is recognized in the appraisal to determine the Net Income Before Debt Service.

Convenience Lease - A lease involving a lessor and lessee who have a close identity with one another; usually used in a case where individuals purchase property and lease it to their corporation. These leases generally are given little or no credence in the credit underwriting of the loan. However, in California, lease payments or guarantees are enforceable in court although loan guarantees are generally not enforceable.

Tax Escalator - A lease provision whereby the tenant (lessee) agrees to reimburse the owner (lessor) for increases in real estate taxes during the term of the lease. Usually, the tenant will pay any excess over the first full year's tax bill.

APPRAISAL DEFINITIONS

Market Value - An estimate of the amount which a property will bring if exposed for sale in the open market for a reasonable period of time, assuming both the buyer and seller are fully informed as to the uses to which the property is adaptable and is capable of being used, and that neither buyer nor seller is acting under compulsion or duress.

Value in Use - Some properties have little or no value to anyone other than the present owner, hence it has no "market value". The value concept with regard to such property (e.g., a college football stadium, church, school, etc.) is the amount the owner would lose if he were deprived of ownership. It is generally based on cost of replacing the property less accrued depreciation.

Cost Approach - An "indication of value" developed as part of the appraisal by estimating the cost of land and improvements if new and then deducting accrued depreciation, if any.

Market Data Approach - An "indication of value" developed as part of the appraisal by comparing the property being appraised with actual sales data relative to comparable or reasonably similar properties and making adjustments for differences.

Economic Approach - An "indication of value" developed as a part of the appraisal by capitalizing the net income before debt service produced by the real estate.

Effective Gross Income - Gross rental income less an allowance for vacancy and/or collection loss.

Capitalization ("Cap") Rate - A rate at which estimated annual net income before debt service is capitalized in order to produce an indication of value. There are several generally accepted methods of developing such a rate, all of which are rather complicated, hence are not discussed herein. In effect, the "cap rate" is merely a composite reflecting a return on invested capital. It is also the lender's way of predicting that the real estate's income stream will continue for the life of the loan.

EXAMPLE:
Net Income $ 80,000
Cap Rate 8%
Indicated Value:
80,000 divided by .08 = $1,000,000

Income Stream - The estimated net income which a property can reasonably be expected to produce over a specific period of time.

Depreciation - Actual or estimated loss in value due to any one or all of the following causes:

Physical Deterioration (ordinary wear and tear)
Functional Obsolescence (inadequacies or super-adequacies)
Economic Obsolescence (loss due to factors outside of the property itself, e.g., inharmonious neighborhood patterns, depressions, etc.)

Note: This is real depreciation and is not the same as the depreciation "allowance" for IRS purposes.

Highest & Best Use - The structure which will produce the highest net return on total investment in a property as a whole, and will maximize the use of the land.

Misplaced Improvements - A structure which does not conform with the principle of Highest & Best Use (see above).

Imputed Rent - The "fair rental value" of an owner-occupied property.

M.A.I. - A member of the American Institute of Real Estate Appraisers. This designation is generally treated with respect because of extremely stringent prerequisites. An M.A.I. is an expert in appraisal of all types of real estate.

S.R.A. or S.R.E.A. - A member of the Society of Real Estate Appraisers. This designation is generally treated with respect becuase of extremely stringent prerequisites. An S.R.A. or S.R.E.A. is an expert in appraisal of all types of real estate.

LENDING OR MORTGAGE DEFINITIONS

Balloon - The unpaid principal balance of a loan at its maturity (the amount of principal not fully amortized within the term of the loan).

Land Balloon - A term referring to an underwriting requirement that the balloon (see above) may not exceed current land value. This is used commonly in "Credit" lending.

Constant Amortization ("Constant") - A ratio number which when multiplied by the loan amount yields the level yearly, or monthly, payments required during the life of the loan. This payment will include interest and principal such that the payment itself remains the same during the life of the loan, but the entire principal has been repaid at the end of the amortization period.

Rapid (or "Accelerated") Amortization - Where, for underwriting purposes, a lender requires that a larger portion of the loan principal be fully amortized during the first several years of the loan term.

EXAMPLE: An older property leased to a strong local tenant for 20 years with a 6%, $100,000 loan justified by the appraisal. On a straight 20-year amortization program, the principal amount amortized over the first 5 years would be only $15,140. Because of the age of the security and the danger of depreciation exceeding amortization, the lender might require that $25,000 be amortized over the first 5 years. In such a case, treat the case as 2 separate loans, one for $25,000, 6%, 5 years and the other for $75,000, 6%, 20 years, both being amortized concurrently. Obviously, the monthly payments will be reduced after 5 years in such a case.

Prime Tenant ("Credit Tenant") - Usually, a tenant (lessee) of substantial net worth with a nation-wide or regional scope of operations. Companies with a $100,000,000 net worth are generally "Credit" tenants.

Purchase-Leaseback - An arrangement whereby one party (A) will contract with another party (B), usually an institutional lender such as a life insurance company, for the second party (B) to purchase a piece of property from (A) at cost and lease it back to the seller (A) on a long-term lease at an "absolute net" rental sufficient to return the total cost of the property, plus interest, over the term of the lease.

EXAMPLE: Continental Can Co. buys a piece of land for $100,000 and desires to build a $200,000 building on it for its own use. Continental contracts with Lender to sell the property for $300,000 with the provision that Continental will lease the entire property back on a 25-year lease at an annual absolute net rental of $23,220 with options to extend the term at a greatly reduced rental.

Co-operative Apartment - An apartment building wherein each "tenant" purchases a stock interest in the owning co-op corporation. Each "tenant" is assessed a monthly charge for debt retirement and operating expenses and the stock holding entitles the owner to occupy a specific apartment unit in the building. California law now allows a mortgage to be made on each individual unit, although the ownership rights are more personal property than real property.

Condominium - Relatively similar to a "co-op" apartment as described above except that each "tenant" has title to their own specific apartment unit within the building together with an undivided part ownership in common with others in all common areas. The condominium owner's title to their own unit is actually to a specific "AIR SPACE" with a building around it.

Townhouse - A condominium in which the unit is typically two-story with no other unit above or below it. The owner receives title, in fee, to the land beneath the unit and an undivided part ownership in common with others in all the common areas (walks, parking lot, pool, recreation room, tennis court, etc.).

Debt Service - Annual principal and interest payments.

Kicker ("Participation") - Where the lender requires the owner to pay a portion of gross income from the building to the lender as additional interest. Usually required only when money is unavailable and usually is a percentage of "Gross" over a certain minimum.

Variable Rate Loans - Where the loan's interest rate is set as a certain percent over a fluctuating index such as "the Prime Rate" or the "Federal Home Loan Bank Cost of Money".

FINANCIAL ANALYSIS

UNDERWRITING GUIDELINES

General Information

Basically, the two sources of financial information available to the lender or lessor are the balance sheet and profit and loss statement.

The balance sheet is a statement of financial position as of a specific date. The profit and loss statement, on the other hand, is for a period of time. This is usually for a period of time covering one year, a quarter, or more than one quarter, such as six months, or nine months with the entire annual accounting period being referred to as the fiscal year.

To provide for continuity in analysis, the balance sheet should be for the date through which the profit and loss statement is applicable. For instance, if the balance sheet is as of December 31, the profit and loss statement should cover the fiscal period from January 1 to December 31. Remember that the entry "Retained Earnings" is the vehicle through which the profit and loss statement relates to the balance sheet.

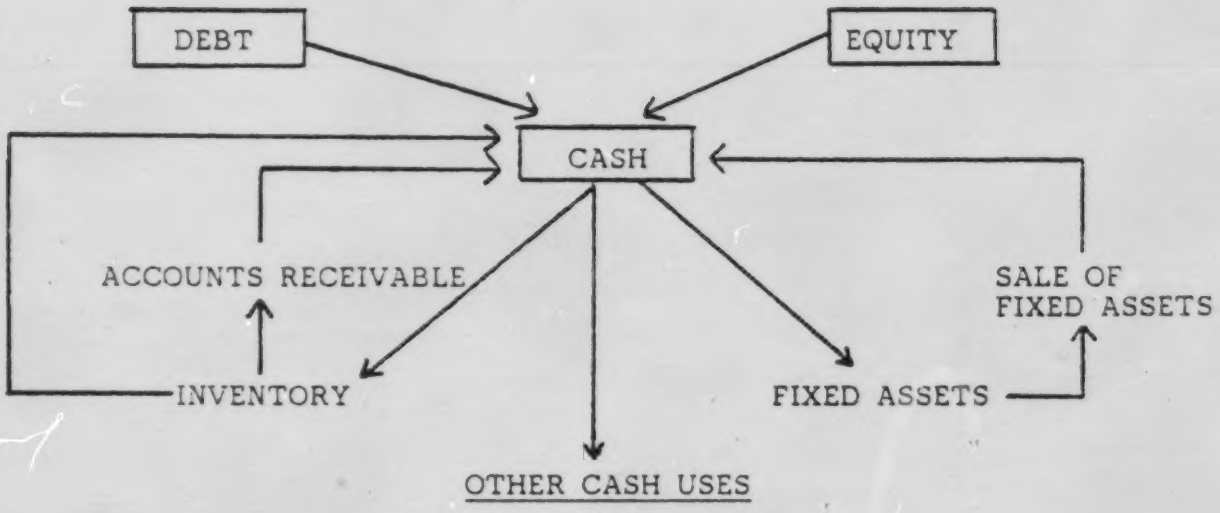
BALANCE SHEET

The balance sheet provides two basic measurements of financial position; liquidity and leverage.

Liquidity

Liquidity is used to mean the percentage of cash to other assets, and as a measure of financial composition, is similar to a statement of the cash cycle. For either the established business, or the new venture, funds are generated in one of four ways: operating revenues, sale of assets, borrowing, and equity contribution. The cash cycle involves the purchase of raw materials, the completion of the production process from raw materials to finished product and the sale. Inventory is converted either directly into cash, or to accounts receivable. Accounts receivable require a further liquidation process to complete the cash cycle. Obviously, the cash basis business affords a more simple determination of the cash cycle, and a more precise measurement of liquidity.

CASH CYCLE



1. interest
2. taxes
3. etc.

There are certain measures of short-term Balance Sheet position that are relevant:

1. Current ratio: That is the total of current assets for the company divided by the total of current liabilities. If the relationship in this observation is one to one, it indicates that there is $1.00 of current assets for every $1.00 of current liabilities. This is a satisfactory rule of thumb. It is necessary that a further consideration be given to the relative makeup of current assets, that is, cash, accounts receivable and inventory. Each current asset is analyzed to determine its substance. Certificates of deposit and unquestionably liquid investments may be given current asset status.

2. Quick ratio: The quick ratio is the total of cash and accounts receivable divided by the total of current liabilities. This is a more exact measure of current position, in that near cash items constitute the only admissable assets in the calculation. You will note that inventory has been omitted in this more exacting measure of liquidity. Any ratio less than one to one implies a dependency on inventory to liquidate short-term debt.

Turnover

The turnover of accounts receivable and inventory is a further measure of position. The turnover of accounts receivable is obtained by dividing net sales by accounts receivable, which indicates the number of times that receivables turnover in the period being analyzed. A higher turnover indicates more rapid collection of sales and greater liquidity of receivables. This is useful, both as an internal comparison with prior calculations, as well as, comparisons with industry standards. The inventory turnover is determined by dividing cost of goods sold by inventory. The higher the ratio of inventory turnover, the more probable the freshness, saleability, and liquidating value of the inventory. Since profit has been eliminated, the cost of sales to inventory gives a more accurate measure of physical turnover. Of course, in its simplest form, the difference between cost of sales and sales is the markup.

Leverage

All businesses employ a combination of borrowed funds and equity funds in their total source of funds, which is the entire right side of the balance sheet. The relative balance between total borrowed funds, and total equity, or contributed funds on the part of the principals, is often referred to as one definition of leverage. For analytical purposes, the Worth to Debt ratio is a description of the balance between creditor debt funds and owner funds. A ratio of $1.00 of owner funds to $1.00 of creditor funds is a generally acceptable observation. Again, relying on this observation by itself can be misleading, and is not a relevant single measure of position for decision making purposes.

A correlary to the Worth to Debt measurement is the Percentage of Debt Financing Relationship, which relates on a percentage basis, total debt to total funds contributed both from borrowing and equity contribution. This observation is relevant when a trend is sought, by observing reasonable number of balance sheet inputs.

PROFIT & LOSS STATEMENT

The Profit & Loss statement indicates the operating success of the business for a specified period of time. That is, a Profit and Loss statement will be for one year, which is a fiscal year in accounting terms, or some other period of time which should be ascertained by the analyst. A percentage analysis with net sales as the base is the relevant analysis of this financial statement. The objective is to determine by a trend analysis significant observations in the percentage comparison among gross profit, operating profit, and net profit before taxes to sales. These relationships analyzed over a period of fiscal years or similar quarterly periods, provide a relevant measure of management performance.

CONCLUSION

After the ratio or financial analysis has been completed, it is absolutely necessary that the financial relationship be compared or analyzed on the basis of individual management depth. The numbers or ratio conclusions by themselves have no meaning unless they are read within the context of management strength. Therefore, it is necessary to obtain a statement of management experience. Obviously, management individuals who have minimum or no experience in a particular business enterprise, must be scrutinized more closely than those who are bringing related experience to a particular business.

A very important question is whether the Operating Cash Flow of a going concern is sufficient to cover the proposed lease or debt service expense. The attached example demonstrates this technique. Failure to cover proposed lease expense from previous Operating Cash Flow indicates that sales must increase to cover the additional burden. Is the required increase realistic?

EXAMPLE

BALANCE SHEET

Old Corporation

December 31, 1977

$(000)

ASSETS		LIABILITIES AND NET WORTH		
Current Assets		Short-Term Debt		
Cash	$ 10	Notes Payable - Banks		$ 50
Accounts Receivable	40	Accounts Payable		30
Inventory	50	Taxes		10
		Accruals		5
Total	100	Current Liabilities		95
		Long-Term Debt		
Fixed Assets	20	Bonds or Mortgages		20
Other Assets	30			
		Total Liabilities		115
		Net Worth		
		Common Stock	5	
		Surplus	10	
		Retained Earnings	20	
		Total Net Worth		35
Total Assets	$ 150	Total Liabilities & Net Worth		$ 150

RATIOS:

LIQUIDITY:

Current Ratio:

$$\frac{\text{Current Assets}}{\text{Current Liabilities}} = \frac{\$100{,}000}{\$\ 95{,}000} = 1.05 \text{ to } 1.00$$

Quick Ratio:

$$\frac{\text{Cash and Accounts Receivable}}{\text{Current Liabilities}} = \frac{\$50{,}000}{\$95{,}000} = 0.53 \text{ to } 1.00$$

LEVERAGE:

$$\frac{\text{Net Worth}}{\text{Total Liabilities}} = \frac{\$\ 35{,}000}{\$115{,}000} = 0.33 \text{ to } 1.00$$

EXAMPLE

PROFIT AND LOSS STATEMENT

Old Corporation

For The Period

January 1, 1977 to December 31, 1977

	$(000)	%
Net Sales	$ 400,000	100.0
Cost of Goods Sold	250,000	62.5
Gross Profit	150,000	37.5
Depreciation	5,000	1.2
Selling Expenses	55,000	13.7
Administrative Expenses	40,000	10.0
Operating Profit	50,000	12.6
Other Expenses	5,000	1.2
Net Profit Before Tax	45,000	11.4
Federal Income Tax	25,000	6.2
Net Profit After Tax (N.P.A.T.)	$ 20,000	5.2

The NPAT of $20,000 was taken into the balance sheet under Retained Earnings. All undistributed (dividends) earnings are maintained in the business in this manner.

TURNOVER:

Accounts Receivable:

$$\frac{\text{Net Sales}}{\text{Accounts Receivable}} = \frac{\$400,000}{\$\ 40,000} = 10 \text{ times}$$

Inventory:

$$\frac{\text{Cost of Goods Sold}}{\text{Inventory}} = \frac{\$250,000}{\$\ 50,000} = 5 \text{ times}$$

LEASE COVERAGE:

A fundamental observation when considering the strength of a building's tenant, in the case of a going concern, is whether historical operating cash flow will cover the proposed lease amount.

Operating cash flow is determined by adding Net Profit After Tax (N.P.A.T.) and Depreciation.

NPAT	$ 20,000
Depreciation	5,000
Operating Cash Flow	$ 25,000

Assume that Old Corporation is presently renting space for $12,000 per year (included in Administrative Expenses), and proposed to lease new space at $20,000 per year. From the Profit and Loss Statement for the fiscal year ended December 31, 1977, it is clear that the proposed rent increase of $8,000 is covered 3.1 times by Operating Cash Flow of $25,000.

$$\frac{\text{Operating Cash Flow}}{\text{Increased Rent}} = \frac{\$25,000}{\$\ 8,000} = 3.1 \text{ times}$$

If Old Corporation cannot cover the proposed rent increase from Operating Cash Flow, the landlord, or lender, should get a statement from management on how this negative observation can be overcome.

FINANCIAL STATEMENTS

For all loans other than apartments, a preliminary and very basic analysis of the tenant's financial statements will save considerable time which might otherwise be wasted if the statements are unacceptable for obvious reasons. The danger signals to look for are:

1. A current ratio of less than 1 to 1. Current ratio is the ratio of current assets to current liabilities. In most cases, a ratio of 2 to 1 (or higher) should prevail.

2. A net worth less than the loan amount requested. The net worth should usually be at least 1-1/2 to 2 times the amount of loan requested, except for apartments, multi-tenant office buildings or multi-tenant industrial buildings.

3. Net losses before depreciation and income tax charges during any of the past five years.

4. Declining or very erratic sales history.

5. Excess funded debt. Funded debt (e.g., long-term notes and mortgages including loan applied for) as a percentage of the net worth should generally not exceed 50%.

LONG TERM
INCOME/COMMERCIAL
REAL ESTATE

INTRODUCTION

INTRODUCTION TO INCOME/COMMERCIAL REAL ESTATE

This section begins with an over-simplified explanation of the basic differences between commercial and residential loan underwriting. Before going into this explanation, however, it might be well to break down the entire mortgage lending field into just two categories, real estate loans and credit loans. Residential financing almost always falls into the category of a real estate loan, whereas with few exceptions (e.g., apartments and multi-tenancy office buildings), commercial loans are "credit loans."

Because there are over 200,000,000 people in this country, all requiring shelter of some sort, there is always a ready and willing market in which to sell residential property (e.g., single family residences and condos). The lender's underwriting patterns are based primarily on the relative marketability of the real estate. It is a very rare instance where a lender will actually take a loss in the process of foreclosing a residential mortgage loan.

Now to commercial, or "income", mortgage loan financing. Property of this type is purchased or developed as a long range income producing investment. So long as the property continues to produce a steady flow of reasonably assured income in an adequate amount, it has marketability. If it has marketability, it can be financed. For underwriting loans of this type (except for apartments and general offices), the lender's primary underwriting considerations, in their order of importance, are:

1. Credit
2. Credit
3. Credit -- and more credit
4. Location
5. Type of real estate and its similarity to other buildings of its type in the area.

The repeated emphasis on credit is a way of saying that even if the real estate is only a tarpaper shack located in a swamp, if it is leased to General Electric or A.T.&T. it is a desirable real estate project.

The only time a commercial loan must be foreclosed is when the property ceases to produce income or produces insufficient income to make ownership a profitable venture. There is probably no greater white elephant than an income property which produces no income or produces income in an amount which does not justify its "brick and mortar" value. Obviously then, if the project is poorly underwritten from the standpoint of the property's income producing capability, the owner and lender must be prepared to take a substantial loss at a foreclosure sale.

The market value of all commercial or industrial property, including apartments, is directly and precisely related to the amount of income it will produce, the reliability or "quality" of the income stream, and the duration of the income stream. For these reasons, there is a wide variance in interest rates, loan-to-value ratios and terms of mortgage financing available for commercial properties.

The relationship between the three factors is:

1. Amount of income furnishes the basis for value.

2. Quality of income furnishes the basis for loan-to-value ratio.

3. Duration of income furnishes the basis for loan term.

The real estate is important only in an indirect way, i.e., if a tenant considers the real estate desirable for his purposes, he will pay a reasonable rent for its use. A lender may be willing to extend the term of his mortgage beyond the initial lease term if the real estate has reasonably good prospects for resale or re-leasing at the end of the lease term. But this is a matter of conjecture, hence its weight for underwriting purposes is of limited significance. Where income producing properties are concerned, the lender concentrates on the "sure thing" aspects of the proposal, which is the existing certain lease term.

While the above explanations are only basic in nature, they should establish a basis for differentiating between a "real estate loan" and a "credit loan".

There are two investors attitudes which bear on income property loans, whether credit or real estate type. The first involves the "principle of conformity" which holds that maximum value is achieved when there is substantial "conformity in use". For example, most investors prefer apartments located in an apartment neighborhood rather than a lone building even though the building might be situated in a good residential area with little competition nearby. In other words, conforming use is preferred to limited competition. The other investor attitude is a general reluctance to finance income producing properties whose income flow hinges on a high degree of management skill. Examples are motels, bowling alleys, hotels, nursing homes, restaurants. In other words, most investors would prefer a U.S. Post Office loan in Anchorage, Alaska to a motel on Rodeo Drive in Beverly Hills or a bowling alley on Fifth Avenue in New York City.

As you can see, income property loans involve complex underwriting which varies considerably with each proposition. On the following pages you will find general underwriting guidelines (simplified) for the various loans which may interest your clients and the typical real estate lender.

UNDERWRITING BY TYPE OF REAL ESTATE

APARTMENTS

APARTMENTS

Loan/Value Ratio

Ratio generally 75-80% of economic value. Therefore, on proposed, rather than existing, projects an 80% loan to economic value may be 85 to 90% of the actual costs. Generally speaking, to make a project economically feasible the actual hard costs (land, brick and mortar, construction loan interest, etc.) should not exceed 85% of the economic value of the project. We are imputing a 15% profit to the builder, developer, entrepreneur.

Where land is particularly expensive or buildings very high-priced, developers are selling the land to a lender, leasing it back and then making a leasehold mortgage on the buildings. This produces a higher debt ratio and provides the developer with some favorable tax advantages. The tax advantage is because land "rent" is a deductible operating expense, where as the land itself cannot be "depreciated" for purposes of IRS depreciation allowances when the developer owns the land.

Rate

In the present market, generally 9 1/4 - 9 3/4%. In most instances no "kicker" or piece of the action is necessary today.

Term

Generally from 25 to 30 years, unless you are dealing with older properties.

Building Requirements

Avoid buildings with open entrance balconies (motel-like). Layouts should be conventional and efficient. Bath access must be off a corridor or hallway; never through a kitchen or bedroom. Soundproofing is becoming a highly significant factor. Likewise, air-conditioning is becoming a must. As a minimum, air-conditioner sleeves must be provided. Adequate on-site parking -- not less than one for one and preferably more. Any building of more than two stories (except the sunken "garden-level" type) must have elevator service. Avoid kitchens that are wide open to a living room. Room and unit size minimums vary among lenders, but, generally speaking, the following should be considered norms:

Efficiency Unit	- 400 Square Feet
1 - Bedroom Unit	- 600 Square Feet
2 - Bedroom Unit	- 850 Square Feet
3 - Bedroom Unit	- 1,050 Square Feet

Living rooms should have no less than a 12-foot width and no less than 220 square feet. "Pullman" type kitchens are acceptable only in efficiency units. No bedroom should be less than 9 feet wide. The master bedroom should have at least 140 square feet, 120 square feet for the second bedroom and 110 square feet for the third. Corridor width should be 5 feet or wider. Adequate storage and laundry space must be provided in the building.

Location Requirements

All lenders prefer an established apartment neighborhood, close proximity to public grade and high schools and to churches and parochial schools. Proximity to public transportation and to shopping facilities also are important requirements. Disqualifying location factors include any non-harmonious use in the immediate neighborhood such as a factory, warehouse, shipping center which might be too close (noise, traffic, lights, etc.), close proximity to railroad lines, neighborhood in racial transition, etc. In addition, be cautious to watch for overbuilding, usually evidenced by unusually high vacancy ratios in competing buildings. Avoid sites on very busy traffic thoroughfares.

Occupancy Holdback

Some lenders will issue a dual commitment on a proposed project, providing for a loan of a certain amount (the "floor") regardless of occupancy status at time of building completion and also providing for a higher amount (the "ceiling") subject to a specific occupancy requirement. The difference between these two amounts is the "holdback". Most occupancy clauses require that 75% to 80% of the units be rented (at rentals projected in the appraisal) on 1-year leases. The amount of the holdback varies from 15% to 20% of the ceiling amount. For construction lending, the bank will consider such a commitment firm only in the floor amount.

Personal Co-Endorsement (Guarantee)

Personal co-endorsement might be required in some cases. Few lenders will consider apartment loans without them. It depends on the lender, the loan to value ratio, and the general acceptance of the deal. Savings and loans usually do not require personal guarantees.

Miscellaneous

Avoid furnished apartments, but where they are furnished, obtain a chattel mortgage on the owner's equity in such furniture, furnishings and equipment. Also appraise the property as though units are not furnished because most lenders can lend only on real estate, not on personal property. Likewise, obtain a first lien on ranges, refrigerators, carpeting, draperies and air-conditioner inserts where such items are included in the appraised value upon which the loan is based. Otherwise, lenders are satisfied with a lien only on the owner's equity in those items. There is a "gray area" as to whether these items are real estate or personal property. For that reason, even though the lender covers them with the first real estate mortgage, they also cover them with a chattel mortgage or U.C.C. Security Agreement. Some investors will include them in the appraisal and lend on them; most others will not.

Valuation

A quick rule of thumb for value is 10.0 times Net Income before Debt Service. In some cases, where real estate taxes are somewhat lower than other areas, or in the case of townhouses where the tenants pay all utilities and there is little or no public area for the owner to heat and maintain, value could be determined as 6.5-7 times gross annual income.

Another way to check it is to take the gross income of a project, deduct 43% for vacancy and expenses, take the remaining 57% as Net Income before Debt Service, then capitalize or divide the net income by 10%.

Example:

Gross Annual Income		$100,000
Expenses and Vacancy		43,000
Net Income		$ 57,000
57,000 ÷ 10% =	$570,000	value
	x 80%	loan
	$456,000	mortgage

$456,000 mortgage = 4.56 times gross income. This is called a Gross Rent Multiple to Mortgage. The value of $570,000 is 5.7 times the gross income and is called the Gross Rent Multiple, (GRM).

Obviously, expenses and vacancy factors will vary somewhat from area to area, especially real estate taxes. It is imperative that you learn and study your own market. A local MAI appraiser or property management firm in your area can assist you in this. The capitalization rate also will vary from lender to lender. Some will be below 10% and others above 10%. Naturally, the higher the capitalization rate, the lower the value.

Further checks you should make on the question of value and the loan to value would be the amount of loan as it relates to the gross square footage area of the building, and the number of units in a building.

Example: $1,500,000 loan ÷ 100 units = $15,000 per unit. (This is typical)
85,000 gross square feet in the building:
$1,500,000 ÷ 85,000 = $11.76 per square feet of gross building area.

Exhibits Required

1. Appraisal Report. If none is available, then furnish detailed data on at least 4 specific comparable land sales and detailed data on competing rentals in at least 4 other nearby projects (explain size of unit, number of bedrooms, utilities and services furnished, appliances included, carpeting, air-conditioning, parking, etc.).

2. Two sets of plans and specifications. Be sure dimensions are shown and that a plot plan, with dimensions, is included. If project is existing, it is still often possible to secure an old set of plans. If not, furnish a Plat of Survey and a floor plan sketch. Plats are easily available from Title Companies.

3. Current credit reports and signed current financial statements on the borrower. If the borrower is a corporation, credit and financial statements on both the corporation and its major principals must be furnished.

4. Map(s), keyed to show subject and its relation to downtown, schools, shopping, comparable apartment rentals and comparable land sales.

5. Set of good color photos showing subject (even if vacant land), street scenes to right and to left, across the street, schools, shopping center, competing units and anything else of significance. These should preferably be mounted, 2 to a page, with typewritten description beneath each photo.

6. Aerial photos if readily available at reasonable cost.

7. Detailed description of the project; including its unit numbers, mix, size, features; the buildings gross area and net rentable area; the building amenities: including laundry rooms, storage facilities, pool, recreation room, tennis courts, garden areas and walkways ("greenbelt"); the site size and features; the parking areas; the proposed ("pro forma") construction costs; and the proposed operating income and expenses. This should be from the borrower as well as the appraiser, if possible.

APARTMENT LOAN UNDERWRITING GUIDELINES

Apartments have assumed an increasing share of the housing market in recent years, and renters have become much more sophisticated in their requirements. There is also a pronounced trend toward larger apartment complexes in order to achieve the maximum efficiency in development and management costs, and economically provide the currently popular amenities, such as swimming pools, tennis courts, putting greens, club and recreation rooms, and sauna baths.

FEASIBILITY

Determination of the feasibility of any particular apartment project is based on an examination of the local economy and rental market, then determining if the project fits the requirements and limitations of the market, and further determining if the project can be absorbed within a reasonable time under current and potential future competitive conditions. The growth factor of the local economy is an important consideration, as well as the appropriate rental range, the "mix" in type of units, the required amenities, and the nature of the competition. The number of units in an apartment project is significant with respect to the size of the local market, and the typical project should be scaled for initial absorption within six months to one year maximum. In those cases involving 100 to 150 units and above, phasing should be considered, with subsequent phases dependent upon a realistic level of rental achievement.

Proposed and newer modern two-story, garden-type projects are generally the most desirable and feasible type of apartment submission. Older apartments (unless modernized) often are not competitive. The high-rise apartment building has its own peculiar problems of acceptance in the local market, arising from two characteristics; the normally higher construction costs and operating expenses necessitating a higher rental scale than similar garden-type units; and the difference in the nature and outlook of the tenants due to the different life style involved. High-rise apartment construction has generally been limited to those high-density areas, such as close-in locations in larger cities, where very high land costs dictate this type of construction. Local acceptance of the high-rise concept should be investigated before entertaining a submission on this type of property.

LOCATION

The importance of a suitable location for any apartment complex has been stressed repeatedly, and it is a prerequisite to most other considerations in evaluating an aparment proposal. A location in an established apartment area with the proposed rental schedule in the same rental category as the existing units is desirable, but sites in newly developing residential areas in the logical line of growth are acceptable, as long as they do not involve "pioneering" too far ahead of the market. Reasonably convenient highway access to sources of employment and shopping areas is also necessary. The quality and nature of the surrounding development should be compatible with the apartment development being considered.

SITE

The site should be adequate in size and configuration to accommodate the improvements without overcrowding, and provide adequate space for on-site parking and the common area amenities. A minimum of 1-1/2 parking spaces per apartment should be required, and 2 spaces per apartment is recommended in most suburban areas. The topography should be reasonably adaptable to the layout of the improvements, and provide convenient access to the public street and highway network. Adequate drainage and availability of all normal municipal utilities is necessary. The nature of the immediately surrounding development is crucial, particularly in the case of small interior sites.

IMPROVEMENTS

The style and aesthetic appeal of an apartment project is becoming increasingly important, and the quality of construction must meet reasonable standards and building codes. (The FHA Minimum Property Standards are the basic guidelines.) Soundproofing is particularly important, with staggered stud or soundboard laminated walls between units and soundboard subflooring or spring clip-suspended ceilings being the minimum acceptable. Lightweight concrete subflooring in combination with wall-to-wall carpeting is the best soundproofing arrangement between floors currently in common use.

Room arrangement should be functional with reasonable zoning of living, utility and sleeping areas. Apartment sizes will vary considerably, depending on local competition and rental category, but generally one-bedroom units of 600 square feet, two-bedroom units of 850 square feet, and three-bedroom units of 1,050 square feet are a practical minimum.

LAND VALUE & CONSTRUCTION COSTS

Construction cost per square foot of living area is a local factor dependent upon labor and material costs, and the quality of construction. $18.00 to $21.00 per square foot for the "bricks and sticks" alone generally covers the current range of submissions. This factor can best be verified through local appraisers and contractors, or by reference to one of the building cost calculator systems. While borrowers cannot rely on this approach as heavily as the economic approaches, it is a means of checking on the validity of the other two appraisal approaches, and should reasonably correlate with them.

A very wide range prevails in land value per apartment unit, depending on site conditions and the local real estate market. Land value ranging from $1,000 per unit in smaller communities or outlying and relatively underdeveloped suburban areas to $7,500 per unit in the more desirable locations in built-up areas of major cities are typical. A competent appraiser will be able to verify the appropriate figure by citing comparables in the market area of the subject property.

SOURCES OF INCOME

The primary income source of an apartment project will, of course, be the individual tenant rentals. However, supplementary income from laundromats, covered parking, and retail and service shops which are part of the apartment complex will be considered in reasonable amounts, where the reliability of the income can be demonstrated.

The most significant basis of comparison between competitive apartment projects is rental cost per square foot, and per unit, per month. Since apartment rent levels are strictly a local competitive factor, it is essential that a number of the comparables in the market area be substantiated and outlined in the appraisal or elsewhere in the submission.

VACANCY

Even in a very favorable rental market, a nominal figure of 5% is usually applied to cover the continuing turnover vacancy and collection losses in a typical apartment project after the initial rent-up period. (The market may be exceptionally strong at the present time, but with the term of apartment loans now up to 30 years, the vacancy will probably average out to at least 5% during the term of the loan.) 10% to 15% or more may be applicable in student or seasonal-type units. A cushion for vacancies in excess of the normal rate is advisable. These may occur periodically for a variety of reasons ranging from rejection of the project due to competitive disadvantages to general overbuilding in the market area.

The most serious problem in determining apartment vacancy situations is the periodic overbuilding cycle. In practically all areas of any significant apartment development, the market is overbuilt from time to time, resulting in abnormally high vacancy rates even in sound well-conceived apartment projects, due to the excessive competition. This condition will normally require from six months to two years or more for correction, dependent upon the area's growth rate and other factors. Short of taking into account the current volume of apartment construction, little can be done to guard against an overbuilding situation occurring anywhere in the future. However, it is essential that current vacancy rates be checked to the extent of available information. Generally, overall vacancy levels of under 5% indicate a favorable market, 5% to 10% is evidence of a softening market, and over 10% vacancy is normally sufficient to avoid consideration of apartment projects until the situation improves. Local offices of the National Apartment Association, the FHA, the Real Estate Board, the Chamber of Commerce, utility companies, major real estate lending institutions, and various other firms and agencies involved in the housing field are helpful in determining vacancy rates.

EXPENSES

Expenses, including minimal replacement reserves of 5% of Effective Gross Income, will vary considerably, depending upon local factors, particularly the real estate tax structure. A base figure (excluding taxes) of 20% to 25% of effective gross income is generally applicable, with real estate taxes ranging

anywhere from 10% to 20% additional, 15% being about average in Southern California. If the landlord does not pay for all or most of the utilities (including heat), 2% to 4% should be deducted from the expense percentages.

APPRAISAL

Since the economic and cost factors of an apartment project are determined locally, the provision of a competent and complete independent appraisal, setting forth specific rental comparable information and detailed calculations in the physical and economic approaches to value, is absolutely essential. A complete and reasonably detailed set of building plans and specifications is also essential in valuating any project which is under construction or proposed. They are also helpful in completed projects, if they are available.

Value by capitalization of net income before debt service is generally considered to be the most reliable of the three approaches to value for income-producing properties, provided that realistic rental and expense figures have been used in determining the net income. A capitalization rate range of 9.5% to 10.5% is generally applicable at present, depending upon the interest rate and the stability of the income stream. Capitalization rates are generally 1/2 - 1% over the first mortgage interest rate.

Particular caution should be used in determining the value of those apartment projects being sold on a syndicated basis. Such sales often involve unsophisticated purchasers, and the sale price may be substantially inflated. The best safeguard in this situation is insistence upon a reliable and independent local appraiser.

MANAGEMENT

The managerial ability of the borrower is an intangible consideration involving a judgement based on analysis of information on the individual's background, and, where possible, personal interviews. To facilitate this analysis, a detailed resume on each of the principals is helpful and should be included with each submission. Often it is indicated that professional apartment management will be hired, but this is considerably less desirable than having owners with demonstrable management ability and experience. The borrower's ability to manage, build or "pay" must be verified with local lenders, real estate brokers and suppliers.

FINANCIAL ANALYSIS

The borrower's financial capacity must be evaluated in relation to the magnitude of the project, and the required balance sheets and profit and loss statements should be supplemented by any necessary clarification. There are no hard and fast rules applying to the borrower's financial circumstances, and lenders tend to look strongly to the real estate in the underwriting of apartment cases. The borrower, however, should be able to demonstrate the availability of funds or other equity sufficient to adequately supplement the first mortgage in completing the construction of the project and sustaining it through a reasonable initial rent-up period or through building or operating cost increase periods.

CREDIT RATING

It is usually a comparatively simple matter to determine a borrower's credit status by obtaining credit reports and/or checking personally with the borrower's business and financial contacts. If a pattern of serious credit difficulties or questionable ethical standards unfolds, then it is advisable to terminate any further consideration of the project regardless of the merits of the proposal otherwise. "Garbage in--garbage out".

RULES OF THUMB

The evaluation of apartment loan transactions, in common with all commercial real estate situations, requires the exercise of judgements based on the particular circumstances of each case, and cannot be reduced strictly to conformity with any system of formulas or mathematical ratios. However, there are a number of meaningful comparisons and ratios which are applicable in determining the acceptability of an apartment submission. Those most commonly applied are as follows:

Loan-to-Value Ratio	$= \frac{\text{Mortgage}}{\text{Value}}$	= 75% - 80%
Debt Service Coverage	$= \frac{\text{Net Income Before Debt Service}}{\text{Debt Service}}$	= 1.25 Times
Default Ratio	$= \frac{\text{Debt Service + Expenses}}{\text{Gross Income}}$	= 80% - 85%
Loan Per Unit	$= \frac{\text{Mortgage}}{\text{Number of Apartments}}$	= $15,000 - $30,000
Gross Income Multiplier	= Gross Income X Multiplier = Value	= 6.0 times to 7.0 times
Loan Per Sq. Ft.	$= \frac{\text{Mortgage}}{\text{Sq. Ft. of Improvements}}$	= $15.00 - $30.00
Average Vacancy & Collection Loss Factor		= 5% of Gross Income
Average Expense Ratio		= 35% of Gross Income After Vacancy of 5%
Average Overall Capitalization Rate		= 9.5% to 10.5% (½ - 1% over Interest Rate)
Mortgage Multiplier	$= \frac{\text{Mortgage}}{\text{Gross Income}}$	= 5.0 times - 6.0 times

SUMMARY

Much of the foregoing information is very general in nature, but most of the apartment lenders' process falls into the above categories. The loan amounts per unit or per square foot could change considerably if higher costs and higher rentals are substantiated. The ratios, however, for Loan-to-Value, Debt Service Coverage and Default Ratio are not as subject to change because of higher construction costs or rentals.

From time to time, market conditions in any particular location or city will vary. Rather than decline all apartment submissions from those areas or cities where overbuilding exists, look at each property on an individual basis, and require increased feasibility, management, and financial strength. Loans in these areas will be more conservative.

A sample apartment analysis is attached, which will demonstrate the ratios we use in underwriting apartment loans, as well as apply the aforementioned "Rules of Thumb".

SAMPLE APARTMENT ANALYSIS

Proposed: 50-unit Garden Apartment Project (two-story, non-elevator) of 50,000 gross square feet with a pool, sauna and recreation room. Situated on 1½ acres of land (65,340 sq.ft.). Two parking spaces per unit included with rent. All units are two-bedroom, one bath, living room, kitchen, patio - 900 sq. ft. Land recently purchased for $200,000. All units are individually metered for utilities, except water.

COST ANALYSIS

Construction Cost (units only) $18.00/sq.ft. x 50,000	$ 900,000
Pool, Sauna, Recreation Room	100,000
Legal, Accounting, Closing, Escrow	20,000
Taxes and Insurance During Construction	10,000
Architectural (Design and Supervision)	30,000
Appraisal, General & Administrative	10,000
Financing Fees (4% x $1,300,000)	52,000
Construction Loan Interest ($1,300,000 x 9 3/4% x 12 mo. x 50%)	63,375
Contingency (3%)	40,000
Subtotal	1,225,375
Land (at cost)	200,000
Subtotal	1,425,375
Developer's Overhead and Profit (15%)	210,000
Total	$1,635,375

SAMPLE APARTMENT ANALYSIS

ECONOMIC ANALYSIS

50 units @ $450.00/mo. ($0.50/mo. per sq. ft.)		= $22,500/mo.	
Laundry Income (@ $5.00 unit/mo.)		= $250/mo.	
Gross Income Yearly:			
Units: $22,500 x 12		$270,000	(99%)
Laundry: $250 x 12		3,000	(1%)
Total:		273,000	(100%)
Less: Vacancy and Collection Loss (5%)		13,650	(5%)
Effective Gross Income:		259,350	(95%)
Less: Operating Expenses:			
Real Property Taxes (15%)	$41,000		
Insurance	2,500		
Water ($10/unit/mo.)	6,000		
Other Landlord Utilities	12,000		
Maintenance & Gardener	10,000		
Management (5%)	13,650		
Reserve for Replacement (5%)	13,650	98,800	(36%)
Net Income before Debt Service:		$160,550	(59%)

SAMPLE APARTMENT ANALYSIS
RATIO ANALYSIS

CAPITALIZED VALUE
Net Income Before Debt Service ÷ Capitalization Rate
160,550/10.0 = $1,605,500

DEBT SERVICE
Mortgage Amount x Yearly Constant
(here 9½% @ 30 years = 10.10 constant)
1,300,000 x 10.10 = $131,300

DEBT SERVICE COVERAGE
Net Income Before Debt Service ÷ Debt Service
160,550/131,300 = 1.23 times

LOAN-TO-VALUE
Mortgage Amount ÷ Capitalized Value
1,300,000/1,605,500 = 80%

LOAN PER UNIT
Mortgage Amount ÷ Number of Units
1,300,000/50 = $26,000

LOAN PER SQUARE FOOT: GROSS
Mortgage Amount ÷ Gross Building Area
1,300,000/50,000 square feet = $26.00

LOAN PER SQUARE FOOT: NET RENTABLE
Mortgage Amount ÷ Net Rentable Square Feet
1,300,000/45,000 = $28.89

BREAKEVEN RATIO
Operating Expenses + Debt Service ÷ Gross Income = 84.3%
98,800 + 131,000/273,000

GROSS INCOME MULTIPLIER
Capitalized Value ÷ Gross Income
1,605,500/273,000 = 5.9 times

MORTGAGE MULTIPLIER
Mortgage Amount ÷ Gross Income
1,300,000/273,000 = 4.8 times

BUILDING EFFECIENCY
Net Rentable Area ÷ Gross Building Area
45,000 sq.ft./50,000 sq.ft. = 90%

RETURN ON EQUITY
Net Income Before Debt Service -
Debt Service ÷ Owners Equity (or Cash Equity)
160,550 - 131,300/335,375 = 8.7%

(Equity is Cost or Purchase Price minus Mortgage Amount;
here we use Total Cost less Mortgage Amount)

PRIME CREDITS

PRIME CREDITS

Definition

A prime or major credit lease is usually to a company with a net worth in excess of $100 million. The leases are generally net, net, net leases (sometimes called "bond" leases). Be careful to read lease carefully to determine Net Income Before Debt Service and to determine under what circumstances the tenant can cancel the lease. If the tenant can leave if an earthquake damages the building or if any portion of the premises is taken in condemnation, the project is very difficult to finance.

You will typically see prime credits such as a Safeway supermarket, Goodyear Tire Store, McDonald's Restaurant, Bell Telephone business office, etc. Frankly, an outhouse in a quicksand area leased by General Motors is financeable.

Loan/Value Ratio

Generally 75% of value or purchase price. However, many investors will go up to 100% of value where there is an absolute net lease and the loan is fully amortized within the fixed lease term. Lenders here will be willing to make a loan having only a 1.05 debt service coverage, and for the right deal, a 1.0 debt service coverage.

Rate

Best rate currently is 8 5/8% to the investor. These loans compete strictly on the basis of rate, since most lenders provide the same amount of dollars and similar amortization periods. The lender determines the rate based on the tenant's Moody's Bond rating and rates charged on comparable companies. Mortgage rate is usually 0.5% higher than the same company's bond rates.

Amortization Period

Fixed lease term plus "land balloon" or "land value hangout" (loan balance at end of fixed lease term should not exceed current land value, exclusive of building).

Building Requirements

Very flexible. This type of loan is underwritten almost exclusively on the credit, hence real estate is of little importance.

Location Requirements

Same comments as under Building Requirements above.

Personal Co-Endorsement

Personal co-endorsements are very seldom required.

Valuation

Capitalize net income (real or imputed) at about 8.75 for rough indication of value.

PRIME CREDITS

Exhibits Required

1. Appraisal, if available. If not available, one will be prepared. Information re comparable land sales should then be furnished, as well as a good neighborhood description to show that land value will be maintained.

2. Two sets of plans and specs, with dimensions shown, together with a plot plan with dimensions. If project is existing and plans are not available, furnish a Plat of Survey and a floor plan sketch.

3. Xerox copy of each signed or proposed lease, together with all exhibits, amendments, etc.

4. Current credit and financial statements on credit tenant. On prime credits which are not nationally known, current credit information (D & B) and financial statements.

5. Set of good color photos of subject, street scenes to right and left, across the street, and anything else of significance.

6. Strip map sketch showing type of occupancy in neighborhood.

7. Map(s).

8. Aerial photos, if easily available at reasonable cost.

LOCAL AND REGIONAL "STRONG" CREDITS

Definition

A company that does not operate nationally but is known as a strong, successful growing local or regional operation. The company's net worth may be as low as $15 million but a significant, long-lasting growth pattern and excellent reputation and market control are present.

You will typically see these credits in free-standing retail stores or in relatively special purpose industrial buildings.

Loan/Value Ratio

Generally 66 2/3% to 75% of value, depending on strength of credit and overall quality of loan proposal.

Rate

Generally 9 1/4 - 9 3/4%.

Amortization Period

Fixed lease term plus "land balloon." If owner-occupied, term is usually 20 to 25 years on retail stores, and 25 to 30 years on industrials.

Building Requirements

Nothing too specific. Generally, look for buildings which are of a general purpose nature that have ready marketability if vacated. Parking should be adequate, usually 5-1 for retail stores, unless a good deal of walk-in trade can be expected.

Location Requirements

Retail stores should be in an area of concentrated population or in an established shopping district. Accessibility is important. Industrials should be in established industrial areas, preferably in modern industrial "parks" close to highways and rail sidings.

Personal Co-Endorsement

The strength of credit and overall quality of the deal will dictate whether personal co-endorsement will be required. In most cases of this type, it is required.

LOCAL OR REGIONAL "STRONG" CREDITS

Valuation

Capitalize net income (real or imputed) at 9.0 to 9.5% depending on strength of credit.

Exhibits Required

Same as for Prime Credit deals, except 3 years of financial statements on tenant are essential.

SHOPPING CENTERS

Loan/Value Ratio

75% of value.

Rate

9.00% to 9.25%

Amortization Period

Traditional lenders will only go to the major lease term(s) plus "land balloon". The theory here is that as long as there is a major tenant in occupancy the "satellite" stores can always be rented. Many lenders will go to 27-32 year terms even with 20 year major lease terms in order to be competitive.

Building Requirements

Nothing specific except that air-conditioning is required, and there must be paved, striped and illuminated parking at a 5-1,000 minimum ratio. This means 5 parking spaces for each 1,000 sq.ft. of net rentable area. Accessibility to the center should be unobstructed. Enclosed malls are preferable to "strip" centers, particularly in areas where weather is a problem.

Location Requirements

In many cases, especially larger centers, the owner or the major tenants will secure a feasibility study (a trade area survey). If possible, get a copy. The most important location factor is density of population within the surrounding trade area. If no trade area survey is available, one should be made.

Leasing Requirements

For the medium and large centers, before a loan proposal will be considered, there should be enough rental income assured from prime tenants on 20-year leases to cover 50-75% of debt service and operating expenses. Either signed leases or "letters of intent" to lease are satisfactory. For small centers, many small investors will finance centers that have major tenants covering less than 50% of debt service and operating expenses (this is called "coverage").

Generally avoid too many non-retail sales tenants because they do not attract a lot of "traffic" to the center. Examples of these are insurance agents, real estate brokers, plumbers, electricians or other service industries, including dentists and doctors. Also avoid having the "lead" or major tenant be a special purpose company. If it is unsuccessful, the center's traffic decreases and the smaller tenants cannot draw enough business to be successful. Examples here are sports centers, theaters, restaurants or stores that sell only one item like records, carpeting, furniture, automotive supplies or electrical appliances, e.g. stereos or refrigerators.

SHOPPING CENTERS

Cost Structuring

As a rule of thumb, a Shopping Center should cost between $24.00 - $37.00 per square foot to build, including all costs, for a Neighborhood Center. A Regional Mall Center will cost $45.00 - $55.00 per square foot to build. Shopping Center loans tend to be 100% of the cost of building a new center.

Expense Structuring

Most Shopping Center leases require the tenant to pay a fixed rental per square foot or a percentage of the tenant's gross sales, whichever is greater. In certain situations, with strong credit tenants, the tenant is allowed to deduct (or recapture) tax, insurance and common area maintenance payments from his gross sales before he pays his percentage. Most leases are absolute net. If they are not absolute net then the leases generally require the tenant to pay any increase in taxes over the "base" or first year ("tax stopped"); any increase in insurance costs over the base year ("insurance stopped"); and the tenants pro-rata share of utilities and common area maintenance costs. There is usually a "merchants association" which advertises for the center and the tenant is usually required to join this association. The tenant pays his own utilities and is usually only provided with the building "shell". This means the tenant fully improves the inside of the store at his own cost (or pays the landlord increased rent, including 10% "interest" over the life of the lease to compensate for the landlords providing the "tenant improvements").

When preparing your Economic Analysis take a 5% Vacancy and Collection Loss on the local tenants only; a 1% Management Fee on the Majors and 3% on the Locals; and a $0.05 per square foot Structural Maintenance figure.

SHOPPING CENTERS

Underwriting

To increase the loan value of the center the major credit's income may be listed separately from the local tenants' income. A lower capitalization rate then can be applied to the major credits income (like a 9.0) while using a higher capitalization rate (like an 11.0) on the local stores' income. Some borrowers are financing the major credits separately from the locals. They will obtain a "prime credit" loan from a credit lender on the major tenant and a different, higher rate and more conservative loan from a different lender on the local tenants. This is hard to do since the lender knows that if the major tenant leaves, the center typically is doomed and the lender wishes some control over the majors.

Many centers have a restaurant free-standing away from the other stores, typically at the end of the parking lot next to the busy street. This maximizes use of the parking lot and rent on these desirable "out-lots" is substantially higher than inside the center.

A Local or Neighborhood center can expect a $24.00 - $37.00 per square foot loan, which typically is 100% of the cost of a proposed or newly built center. A Regional Mall can expect a loan of $45.00 - $55.00 per square foot, likewise 100% of the building costs of today's center.

Definitions:

Local or Specialty Shopping Center: A smaller center with only local tenants. Typically 25,000 - 50,000 sq. ft. in size.

Neighborhood Shopping Center: A medium size center between 50,000 - 250,000 sq. ft. Typically the "anchor" or "lead" tenants are a Supermarket and a Drug Store.

Regional Shopping Center (Mall): One with 250,000 - 1,000,000 sq. ft. Typically anchored by Sears, J.C. Penney and a Supermarket.

Personal Co-Endorsement

Not usually required.

Valuation

Figure value at about $20.00 - $25.00 per sq. ft. of building area (this should cover all building costs including paving, indirect costs, etc.), then add land value. Another rule of thumb (very rough) is to figure value at 9 times gross annual income.

Exhibits Required

Same as for Prime Credit deals.

OFFICE-WAREHOUSE

OFFICE-WAREHOUSE

Definition

A building containing 10-15% offices in the front with unobstructed and undivided warehouse, storage or light manufacturing space adjoining the office. The office portion may be one-story; however, the warehouse portion will typically be 16-18 feet high with no obstructions on the floor or up to the ceiling. The warehouse portion will have several 14 feet by 14 feet overhead doors leading to truck loading platforms or areas. The site will have adequate off-street parking (2-1,000 feet) and will allow easy passage of large trucks.

Loan-to-Value Ratio

Ratio generally 75% of economic value. Loans are generally in the range of $13.00-15.00 per sq.ft. The lender will require a 1.25 debt service coverage.

Amortization Period

Generally 25 to 30 years unless you are dealing with older properties.

Building Requirements

Minimum 14 feet "clear under beam" of height unobstructed in warehouse portion. Require 1 parking space for each 500 sq.ft. of warehouse and for each 250 sq.ft. of office. 14 feet high and wide overhead truck loading doors in warehouse and easy passageway for large trucks on the site. Office space relatively conventional and facing the street so that there can be company identification on the door of the building facing the street. At least one each men's and women's bathroom typically near the door opening from the office to the warehouse portion. The modern buildings have either steel "beams" or "glue-laminated" and fireproofed wooden beams as the ceiling supports in the warehouse. The offices frequently have a second floor opening onto the warehouse portion as extra mezzanine storage area.

The building should be completely multi-purpose with virtually no special features except heavy electrical availability and/or extra thick floors.

Location Requirements

Established office-warehouse or industrial area, preferably in a modern industrial "park." Site should have easy access to major highways.

Valuation

A rule of thumb is to capitalize Net Income Before Debt Service by a 9.5-10.0 capitalization rate. The building should cost $12.00-$14.00 per square foot to build, then add the land value to determine cost valuation. Since the landlord typically pays only structural maintenance and first year taxes and insurance, operating expenses and vacancy are usually 20-25% of gross income.

Personal Co-Endorsement

Generally required.

Interest Rates

Typically 9.5 - 10.0% today.

Exhibits Required

Same as for apartments except including a copy of the executed or proposed leases and detailed financial information on the tenants, if available.

MULTI-TENANT
OFFICE BUILDINGS

GENERAL OFFICES (Multi-Tenancy)

Loan/Value Ratio

70% to 75% of economic value. The lender will require a 1.20 debt service coverage. Loans are generally $25.00-$35.00 per square foot.

Rate

9 1/4% to 9 3/4%.

Amortization Period

Generally 25 to 30 years. Some lenders will go to 32 years to make a deal work.

Building Requirements

No specific rules. On-site parking should be adequate, which means 1-250 square feet (except for downtown buildings). Building should be of a general purpose nature, suitable for occupancy by any typical office space user. Air-conditioning is essential. Any building with more than one story must have an elevator. Hallways should not be too wide and bathrooms must be readily available.

Location Requirements

An established office building neighborhood, close to public transportation and on a major cross street.

Valuation

A rule of thumb is to capitalize Net Income Before Debt Service by 9.5 to 10.0 capitalization rate. The building should cost $35.00-$45.00 per sq.ft. to build, including the land, unless it is a downtown location. The landlord typically pays for all utilities but the tenants pay increases in taxes, insurance and maintenance costs over the first (base) year. Rental rates are typically $0.60-$0.75 per sq.ft. monthly in the suburbs and $0.75-$1.00 per sq.ft. monthly in a "downtown" high rise location. Operating expenses plus vacancy average 35.0% to 45.0% depending on the real property tax structure of the area. Office buildings should be no less than 90% efficient.

GENERAL OFFICES

Personal Co-Endorsement

Generally required, unless there are a high percentage of long-term leases with good tenants.

Leasing Requirements

Most lenders will issue a "floor-ceiling" commitment similar to the holdback for occupancy as used in apartment lending. Lenders will also "hold back" $10.00 to $15.00 per sq.ft. for unfinished office space, since that is typically what it costs to finish the space. It is preferable that there be some leases or letters of intent to lease so that a rental rate pattern can be established.

Exhibits Required

Same as Office-Warehouse.

MEDICAL OFFICE BUILDINGS

Definition

An office building designed specifically for use by doctors, dentists and related medical service suppliers (laboratories, X-ray, psychologists, speech therapists, etc.). Medical offices have many more sinks and heavy electrical availability. The larger buildings will have a pharmacy and coffee shop on the street level, while smaller buildings have such facilities nearby.

Loan/Value Ratio

75% of economic value. The lender will require a 1.20 debt service coverage. Loans are generally $50.00-$65.00 per sq.ft.

Rate

9 1/4% to 9 1/2%. Lenders love owner-occupied or doctor-owned medical buildings.

Amortization Period

Generally 25 to 30 years with some lenders going to 35 years to make the deal work.

Building Requirements

If building has more than one story, require an elevator adequate to carry a patient on a stretcher. On-site parking minimum of 10 cars per doctor. Air-conditioning is essential and building should be suitable for occupancy by any typical doctor.

Location Requirements

Must be near hospital or in established "downtown" medical office location unless small owner-occupied building. Building should be on a major street with public transportation facilities.

Valuation

Use a 9.5-9.75 capitalization rate on the Net Income Before Debt Service. The building should cost $60.00-$70.00 per sq.ft. to build, including the land value, unless it is a "downtown" location. The tenant typically pays all utilities and increases in taxes and insurance over the first (base) year. Rental rates are typically $1.00-$1.10 per sq.ft. monthly in the suburbs and $1.15-$1.25 per sq.ft. monthly in a "downtown" high rise. Operating expenses plus vacancy average 30.0% to 40.0% depending on real property taxes. Remember, doctors are very sensitive to being treated nicely, so building services are essential.

MEDICAL OFFICE BUILDINGS

Personal Co-Endorsement

Doctor owner-occupants must either guarantee the loan or personally lease offices on long leases. Non-doctor owners generally must guarantee the loans.

Leasing Requirements

Most lenders will issue a "floor-ceiling" commitment similar to the hold backs for occupancy as used in apartment lending. Lenders will also "hold back" $15.00-$20.00 per sq.ft. for unfinished medical office space since that is typically what it costs to finish it. It is preferable to have leases to establish the rental rate pattern.

Exhibits Required

Same as Office-Warehouse, except biographical resumes on the doctor owner-occupants are essential.

MOBILE HOME PARKS

Definition

A developed area where residents rent space on a semi-permanent basis for their Mobile Home "coaches." The project appears to be a cluster of single story free standing metal apartments. Each Mobile Home pad typically has its own paved patio and is covered by gravel or crushed stone. Many parks are situated adjoining a mobile home coach sales facility typically owned by the park's developer.

Loan/Value Ratio

Generally 65% - 70% of value. Lenders use a 1.40 debt service coverage and will capitalize net income before debt service at 1% over the mortgage interest rate.

Rate

Generally 10 1/4 - 10 3/4% today.

Amortization Period

20 - 25 years.

Building Requirements

Mobile Home Parks are rated by a service called "Woodalls." A high quality park will have a "Four or Five Star" rating. Parks should have all underground utilities to each pad ("hookups"). Generally the park has one main entrance for better control of ingress and egress. The park should be served by a main street and nearby schools and shopping.

Five Star parks generally have a density of no more than 7 pads per acre. Each "single wide" coach pad should have not less than 3,600 sq.ft. A "double wide" coach pad should have 4,000 sq.ft. The pads typically have a 180 sq.ft. paved patio and are covered by crushed stone or gravel to control weeds and minimize maintenance. Off street parking for two (2) cars per pad is a minimum.

The park itself will generally have a combined office and recreation room along with a children's playground, pool and car wash area. Better parks have tennis courts, exercise facilities and a recreational vehicle parking area. If the park allows both couples with children and adults only they should be in separate areas.

Location Requirements

Access to schools, shopping and business. Parks are frequently located as buffers between residential and industrial areas of a city.

MOBILE HOME PARKS

Valuation

A rule of thumb is to use a 10% vacancy and collection loss and 35% operating expenses. Land costs generally run 15 - 20% of the total construction costs per pad. The typical cost per pad is $7,000 - 9,000 with loans averaging $5,000 - 7,000 per pad.

Personal Co-Endorsement

Generally required.

Exhibits Required

Same as for apartments except including detailed description of the park's manager since Mobile Home parks require highly skilled managers to be successful.

HOTELS AND MOTELS

Loan-to-Value Ratio

Ratio generally 70 - 75% of economic value. Loans per room vary from $6,000 - 8,000 for an "Economy" hotel without a restaurant to $12,000 - 15,000 for an urban location with a restaurant and modest convention facilities. The lender will require a 1.5 debt service coverage.

Amortization Period

Typically 25 - 30 years.

Building Requirements

Each geographic area has its own typical building design. Minimum parking ratios require 1.25 parking spaces per room not including parking for dining/meeting or cocktail facilities. In colder areas "outside" hallways are undesirable.

Soundproofing between rooms is important and a full bath should be required. An indoor pool in a colder climate is a necessity as are convenient lobby, cocktail and restaurant facilities. Efficient hotels have a minimum of 125 rooms with a restaurant and cocktail bar and 100 rooms for an Economy hotel without a restaurant.

Various services analyze and advise on a hotel/motel's feasibility. Perhaps the best known are Harris, Kerr, Forster and Company, Chicago, Illinois ("Trends") and Laventhol, Krekstein, Horwath and Horwath, Chicago, Illinois ("Lodging Industry"). Both companies publish yearly area statistical reviews whose name is contained in the parentheses following the company name. These feasibility studies "make or break" the hotel/motel submission.

Economy hotels cost between $20.00 - 25.00 per sq.ft., with the hotels with restaurants ranging from $25.00 - 35.00 per sq.ft.

Location Requirements

Downtown, airport or other "Destination" hotels are almost the only ones financeable today. Highway access is a must. A balance must be struck between being in a hotel area where there is "action" and an area which has overcompetition. Recreational area hotels are virtually unfinanceable.

HOTELS AND MOTELS

Valuation

Typical hotels do not break even until they attain a minimum 70% occupancy level. For hotels without a restaurant add approximately 10% to Effective Gross Income for income from telephones, laundry and vending machines. In a Motor Hotel presume 60% of Gross Income is from the rooms and 40% from restaurant, bar, telephone and laundry income. After Net Income Before Debt Service - Room Operations is determined subtract a "Rental Return from Furniture and Furnishings" of 10% per year for the cost of such items. This is to compensate for the high replacement cost of these items and because lenders like to determine what the real estate "alone" will produce. These are frequently financed separately but the lender requires a security interest on these items.

Personal Co-Endorsement

Generally required.

Interest Rates

Generally 10⅛ - 10½% with the lender receiving a "kicker" of 5% of gross income in excess of scheduled initial gross income.

Exhibits Required

1. Feasibility Study and Appraisal.
2. Site Plan, Floor Plan, Building Elevation.
3. Management Resume and Contract.
4. Construction Cost Breakdown, including Land Purchase Contract.
5. Estimated Income and Expenses.
6. Site Map and Aerial Photographs.
7. Owner/Borrower Resume and signed, current financial statements.
8. Details on the furniture and furnishings design and financing.
9. Resume and financial statements on the General Contractor.

NURSING HOMES

Definition

A longterm residential health-care facility which provides one or more of the following services:

1. Room, board and social programs - this is called "Residential Care."

2. Assistance in walking, dressing, bathing and food preparation - this is called "Personal Care."

3. Full-time nursing and medical care - these typically are called either "Extended Care", "Intermediate Care" or "Skilled Nursing" homes.

All homes are licensed and categorized by the state or municipality. The terms described in paragraph 3 above refer to certification for eligibility to participate in various U.S. Governmental cost reimbursement programs. The primary federal programs are Medicaid (Title XIX) which assists low income people of all ages; and Medicare (Title XVIII) which assists persons over the age of 65.

A municipality must issue a "Certificate of Need" before a home may be licensed.

Loan-to-Value Ratios

Ratio generally of 65 - 75% of economic value. Loans generally in the range of $7,000 - 9,000 per bed. The lender will require a 1.5 debt service coverage.

Amortization Period

Generally 20 to 25 years.

Building Requirements

Modern, efficient homes are generally over 100 beds. The site should have good access to public transportation (for employees) and visitor parking of one space per every five (5) beds. Most homes are one-story with a central nursing station no further than 100 feet from the farthest patient bed. Each home should have its own laundry, dining and food preparation facilities even if such services are provided from outside the home. A "for-profit" or "proprietary" home should not have an excess of non-income producing space such as chapels and visitors' lounges.

Homes typically cost $10,000 - 15,000 per bed including land. The cost of equipping the home is from $1,000 - 1,500 per bed. Equipment is typically financed separately on a short-term loan; however, the buyer or lender should obtain a security interest in the equipment.

NURSING HOMES

Homes are required to have a licensed administrator and be fully staffed to comply with licensing requirements. Sophisticated continuing management is an absolute must.

Location Requirements

Preferably middle-class residential areas served closely by a hospital or doctor's office.

Valuation

A rule of thumb is to use a 15% vacancy and collection loss and an overall 80% factor for operating expenses for a home providing nursing facilities. A residential care facility's expense ratio will generally be 75%. A home will usually need 12 - 18 months to "rent up" to 85% occupancy and an operating loss reserve should be underwritten into the costs. Capitalization rates average 2% over the interest rate.

Personal Co-Endorsement

Generally required.

Interest Rates

Generally 10 1/4 - 10 3/4%, if loans are available at all from "conventional" lenders. Many homes are financed with FHA insurance.

Exhibits Required

Same as for apartments except detailed information on management and the Certificate of Need and supporting documents.

SHORT TERM LOANS

INTRODUCTION
TO
SHORT TERM
UNDERWRITING

INTRODUCTION TO SHORT-TERM UNDERWRITING

This section will deal with four basic types of financing:

1. Land Acquisition Loans
2. Land Development Loans
3. Construction Loans Without Permanent Commitments
4. Construction Loans With Permanent Commitments

These four basic types have several things in common;

1. Short-term, never to exceed 5 years
2. No amortization (interest only)
3. High risk, therefore high interest rates
4. Always require strong credit and personal guarantees
5. Interest rates typically are tied to and float with the prime rate which can be adjusted daily.

Despite all of the common characteristics, these loan types differ dramatically in how they are structured. The following chart briefly summarizes the basic characteristics:

LOAN TYPE	RISK RATING	TYPICAL LOAN TO VALUE RATIO	TERM	TYPICAL INTEREST RATE	LENDERS FEES	RELEASES	BASIS OF VALUE
1. Land Acquisition Loan (Zoned Land)	Highest	50%	2-4 Yrs.	Prime Rate + 5-6%	1-3%	120-130% of Loan/Acre	Acquisition Price
2. Land Development Loan*	Very High	60-70%	1-3 Yrs.	Prime Rate + 4½-5¾%	1-2½%	115-125% of Loan/Acre	M.A.I. Appraisal of Fully Improved Value
3. Construction Loan Without Permanent	High	70-75%	12-24 mos.	Prime Rate + 3½-4½%	1-2%	110-120% of Loan/Unit	M.A.I. Appraisal of Resale Value
4. Construction Loan With Permanent	Above Average	75-80% (never more than amount of takeout) (If construction costs greater than Permanent loan may get "gap" loan for difference)	12-24 mos. (never longer period than takeout effective period)	Prime Rate + 2-3%	0-1%	100% on Completion of Construction and Funding of Permanent	M.A.I. Appraisal Value Based Primarily on Economic Value

*To perform the acts of subdivision which include platting engineering, soils testing, curbs, sidewalks, utility installation and carrying costs. Rule of Thumb is expected sales price of "developed" land should include 1/3 Profit, 1/3 Land Cost (Raw) and 1/3 Development Costs.

LAND ACQUISITION LOANS

As noted on the preceding chart, land acquisition loans are the riskiest type of real estate loan. This relates to the fact that the only way to repay the loan is to sell the ground or to roll it into another loan, usually a development loan. In most cases the acquisition loan is a part of the development loan. The loan to value ratio is low and the rate is high, because no lender really wants to make this type of loan. Conversely, most developers will finance their land acquisitions through land contracts or purchase money mortgages taken back by the sellers, because it is cheaper. Perhaps the most common method of controlling land is to option the ground subject to zoning or soil tests or some other contingency. While the option price is a sunk cost, it still is cheaper and safer in the event the land can't be used for its intended purpose. Remember, land itself has no intrinsic value. Value is created only through its eventual use and production of income.

Lenders generally will not finance pure land speculation. The type of land acquisition loan easily obtainable is one where the owner is borrowing based on the owner's personal or corporate credit with very little concern for the eventual value of the land acquired. Interestingly enough, the only kind of pure real estate loan reduces to a pure credit situation.

Exhibits Generally Required:

1. Financial Statements
2. Offer to Purchase with Acceptance to demonstrate acquisition cost
3. Where possible the other exhibits required for Land Development Loans, which are described on the following page.

LAND DEVELOPMENT LOANS

The only reason for a land development loan is to pay the improvement costs of a project which will take several years to complete, for example, a subdivision, townhouse complex, or large industrial park. Note the crucial difference between a development loan and an acquisition loan - THE SPECIFIC USE HAS NOW BEEN DETERMINED. Zoning alone does not determine specific use. The land, at this stage, has been planned with utility and street layouts and a preliminary plat has usually been prepared.

Lenders will typically provide all of the dollars necessary to acquire the land, put in all of the improvements and pay the carrying costs for the term of the loan. These loans will average 2/3 of value on completion of the developed subdivision without any buildings constructed on it. (e.g., what the "ready-to-build" lots would sell for.). In most cases the land cost will be 1/3 of final value and the improvement and carrying costs will be 1/3 of final value. This leaves 1/3 of value as profit. If the cost figures supplied by the developer vary by more than 10% from these ratios - watch out! This is a good indication that something is wrong. Maybe the developer is over-paying for the land or his estimated improvement costs are off. In any event, be alerted to the fact that something is wrong. Unless there is at least 30% profit, chances are the deal is not worth doing. If the lender will make a loan where there is less than a 30% margin, the difference will have to be supplied in equity funds by the developer. (e.g., more payment of costs, up front, by the borrower.).

Typically, the lender will insist on a covenant to do all of the eventual construction financing at the prevailing market rates. Releases are obtained by repaying the development loan at something between 115% and 125% of the loan per acre. The funds would generally come from the construction loan which is made under another set of terms and conditions. The intent of the release clause is to get the development lender out of the deal early. By accelerating the repayment, the lender has been fully paid back when approximately 80% of the land has been used. It also serves to keep the developer's profit in the last 20% of the land, i.e., dollars received on the first 80% of the land sold or refinanced are used to retire the debt.

Exhibits Required:

1. Developer's financial statements, credit reports and D&B's
2. Resume of construction experience of developer
3. Site information
    a) Survey and Legal Description
    b) Site Plan showing streets and utilities, either preliminary or final
    c) City Map showing project location and other significant developments nearby
    d) Aerial photos

4. Cost estimates of the improvements to be made, including interest cost and fees

5. M.A.I. appraisal of completed value

6. Project timetable showing start of development, phasing, total estimated time to complete and project useage pattern

7. Cash Flow projection of dollars to be paid out and dollars to be received and when.

CONSTRUCTION LOANS WITHOUT PERMANENT

The most common use for this type of financing is the condominium or for-sale townhouse project being built without presales. Quite obviously, since the ultimate owners of the units are not known, there can be no real permanent commitment. In the case of condominiums and townhouses most constructon lenders require a "take-out" commitment being available. This is an agreement by an end lender to provide the "home loan" to the ultimate borrower, typically at then current rates and terms.

Taking the place of a permanent mortgage commitment in the case of other projects which typically have permanent loans (office, shopping center, etc.) is a "standby commitment". A standby is necessary because, by law, no commercial bank can make a construction loan without a commitment from somewhere to take it out on completion. A standby is, is a commitment made, usually by the construction lender itself to pay off its own construction loan at completion with a very short term "permanent" mortgage. This "permanent" mortgage is non-amortizing, usually for a term of one year longer than the estimated construction period, and at some ridiculously high rate of interest. Quite obviously, they are never intended to be funded. They are primarily a device to enable commercial banks to do this type of construction financing. The combination of a construction loan and a standby commitment is sometimes referred to as "bridge financing", i.e., it bridges the gap between the start of construction and the sale to and financing of the ultimate buyer. Although R.E.I.T.'s technically don't need standby loans to make the construction loan the cost of their funds is higher than that of commercial banks and they need the extra fees to make a big enough profit to justify the risk.

Bridge financing is usually available in an amount up to 70% of M.A.I. appraised resale value of the completed building. The loan amount should be sufficient to pay off the underlying development loan, if one exists, or to pay all acquisition and improvement costs if it is a one phase project. In addition, it should cover all construction costs, marketing costs, and carrying costs. In other words, this type of loan will pay for almost everything but sales commissions and developer profit. As with the development loan, repayment is accelerated by using a release clause which requires from 110-120% of the loan per unit to be repaid in order to clear the individual unit for pemanent financing in the case of condominiums or townhouses. In the case of the other projects, the loan is paid in full from the proceeds of the permanent loan ultimately obtained, typically after completion and leasing of the project. Once again, as with the development loan, any funds required from the lender in excess of 70% of value should be a danger signal and if the lender is willing to make the loan at all, it will be with the funds required in excess of 70% considered front-end equity and escrowed for payment of bills beyond the loan amount.

CONSTRUCTION LOANS WITHOUT PERMANENT

While this kind of financing is still very risky, it is safer than acquisition and development financing. The only reason it is safer is that the project is being brought closer to mass marketability. In other words, the lender's risk of losing his mortgage investment is being reduced. Nonetheless, the risk is still very high in the spectrum of real estate finance. Not until the project is completed does the risk go down another notch, and not until the project's saleability has been demonstrated does the lender begin to breathe easier. We want to strongly emphasize that building and selling condos is not for amateurs. Not only does the job require the normal construction expertise, but it requires that the developer have available a top-notch marketing capability. Lenders will usually require strong financial statements and personal guarantees for a construction loan without permanent, particularly on a "for-sale" condo or townhouse.

Always keep in mind that you are usually building and financing a "spec" subdivision - nothing more and nothing less! The best guide is common sense in your approach to feasibility: Do the unit designs make sense with regard to room sizes and traffic patterns? Are the units priced right for the area? How is the access? Are there shopping facilities nearby? Most of all, who is the potential buyer or lessee and does the unit fit their needs?

You should learn their market. If it is a "for-sale" condo or townhouse, tell the client to take their spouse out and look at the competition. Pick up sales brochures; ask about square footages and prices. Figure out what the project sells for per square foot. What amenities are included? Which features are standard and which are optional? All of this information is necessary before you can properly apply common sense. Local sales or rental brokers are a vital source of good "prediction" and present day information.

Exhibits required:

1. Developer's financial statements, credit reports and D&B's.

2. Resume of construction experience & marketing experience

3. Site information

    a) Survey and legal description
    b) Site plan finally approved
    c) City map showing project location and other significant developments
    d) Aerial photos

4. Approved plans and specs

5. Construction cost statement

6. M.A.I. Appraisal of resale value

7. Project timetable showing starting date, phasing, estimated construction time, and sales projections.

8. Homeowner's Association Documents

9. Resume on Manager and Leasing or Sales Agent for the project.

CONSTRUCTION LOANS WITH PERMANENT

Only a few permanent lenders also provide construction loans. The exception to this general rule is the California Savings and Loans who emphasize single family and multi-family (apartment and condo) loans and are usually less competitive in their financing of non-residential projects. This is because Savings and Loan regulations require them to loan approximately 90% of their funds on residential properties. Many Savings and Loans will not provide construction loans. Therefore, once a permanent loan commitment has been obtained by a developer for an apartment complex, office building, etc., he then takes this commitment along with his entire permanent loan submission to his commercial bank to secure a construction loan. The construction lender is concerned first with the validity of the permanent commitment and then with the developer's cost estimates and his ability to perform. At all times there must be sufficient funds available to complete the project. The permanent loan will not become effective until such time as the project is completed substantially according to plans and specs. In other words, the construction loan will never exceed the amount of the permanent commitment and if the estimated costs are greater, the developer will have to put in equity dollars front-end to keep the construction loan in balance.

Most Mortgage Bankers do not provide construction loans themselves, although many did so in the past. Therefore, the Mortgage Banker's involvement relates only to its ability to help the developer negotiate his construction loan. The Mortgage Banker, or others, can assist the developer in reducing its money costs by supplying the construction lender with non-interest bearing compensating balances. This reduces the Bank's cost of funds which can then be passed on to the developer. Some Banks will require both compensating balances and establishment of account relationships in order for them to provide construction financing. Frankly, although establishing account relationships may not be required, it is usually extremely helpful.

Exhibits Required:

Same as for "Construction Loan Without Permanent", except add the Permanent Loan Commitment and Financial Information on the Permanent Lender, when necessary.

THE INTERMEDIATE-TERM LOAN

The concept is a loan whose term is from one to ten years, with long-term amortization schedules similar to permanent mortgages, with liberal prepayment privileges and rates usually within 1/2% of the long-term market rate for comparable properties. This gives the developer a firm permanent loan, so the construction lender is assured that the building loan will be repaid upon completion of the property. Therefore, the construction loan rates and underwriting patterns will be those of a Construction Loan With a Permanent.

Developers often use an intermediate-term loan as a "fundable standby" to secure a construction loan without first going through the often protracted application for a long-term loan. In addition, the developer may wish to begin construction immediately to take advantage of a favorable labor market or avoid unfavorable seasonal building conditions. The developer may also be concerned about the interest rates then current on long-term funds, or capitalization rates, and may wish to shop for his permanent loan in a more favorable money market. Most Long Term (Permanent) Loans contain heavy penalties for paying off the loan prior to maturity. Some do not allow any "pre-payment" during the first ten loan years. The Intermediate Term loan is slightly higher in interest rate but allows "pre-payment" at any time. This encourages the developer to refinance with an advantageous permanent loan at the right time. In addition an existing and proven project usually commands more attractive long-term financing than a proposed project. By using an intermediate-term loan until the project is completed and leased, the location is established and the grass, trees, and bushes are in place, the developer can seek a permanent loan with the location and aesthetics proven.

Perhaps the most commonly thought of external condition favoring refinancing is the inflationary spiral. It seems to be an economic fact of life that income properties can be expected to produce higher rent rolls year after year, and this would suggest higher loan amounts. However, increasing operating expenses, higher interest rates and real physical depreciation of the property, may offset increased rentals and neutralize the benefits of intermediate-term financing for the developer who wants to build at today's costs and finance at tomorrow's rents. A more subtle implication of the economic climate relates to the phenomenon of peaks and valleys of rental demand. Permanent lenders often react simultaneously to a strong or weak rental market. When there are few or no vacancies in a given locality, lenders easily fund new developments. Unfortunately, this enthusiasm sometimes creates an oversupply, and demand is exceeded. Then, because of the over building, lenders will not resume financing until most of the vacancies are absorbed. However, because of the substantial time lag between financing a building and its availability for rental, the sophisticated developer may wish to begin construction even when a glut of space is still on the market if he is confident that the excess supply will have been absorbed by the completion of construction. If that is correct, use of the intermediate-term loan would allow the developer to time permanent refinancing to the long-term lenders' return to the market.

The typical intermediate-term loan has a 25 year amortization schedule but must be repaid by the end of the 3rd, 4th or 5th year. The loan-to-value ratio and other terms are similar to Permanent loans, except the interest rate is 1/2% to 1% higher than those on Permanent loans available at the time of application for the Intermediate-Term loan. There are no "pre-payment penalties" or "lock-in" periods.

Resume of the Author

Robert S. Apfelberg is the Vice President-Income Commercial Production of Bowest Corporation, Los Angeles. Bowest, the country's sixteenth largest Mortgage Banker, is a wholly owned subsidiary of the Bowery Savings Bank, New York, the second largest institution of its kind, with over $4.7 Billion in assets.

Mr. Apfelberg grew up in Milwaukee, Wisconsin. He graduated in 1966 from the Wharton School of Finance and Commerce, of the University of Pennsylvania, Philadelphia. Mr. Apfelberg received a Bachelor of Science in Economics degree majoring in Finance. In 1969 he received a Juris Doctor degree from the Law School of the University of Wisconsin-Madison. After serving a one year legal clerkship on the Seventh Circuit, United States Court of Appeals, Chicago, he was associated with the Los Angeles law firm of Pacht, Ross, Warne, Bernhard, Sears and Nutter. Mr. Apfelberg specialized in Estate Planning and Real Estate.

During 1973, Mr. Apfelberg became the Southwest Regional Vice President of the Income/Commercial Loan Department of Mortgage Associates, Inc., Milwaukee, who are a subsidiary of the Industrial National Bank, Providence, Rhode Island. In early 1975 he moved to his present position with Bowest Corporation. He has served as the company's General Counsel and is presently supervising the Income/Commercial Loan Servicing Department in addition to his duties as Vice President-Income/Commercial Loan Production.

Mr. Apfelberg is 33 years old and resides in the Woodland Hills area of Los Angeles.

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